

FEDERAL RESERVE SYSTEM

12 CFR Part 210

[Regulation J; Docket No. R-1202]

Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers through Fedwire

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors is publishing final amendments to Regulation J to provide for the rights and obligations of banks and Reserve Banks relating to electronic items handled by Reserve Banks. These amendments ensure that Regulation J covers the electronic check processing service options that the Reserve Banks will offer when the Check Clearing for the 21st Century Act takes effect on October 28, 2004. The final amendments also clarify some existing provisions of Regulation J.

DATES: This rule is effective on October 28, 2004.

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SUPPLEMENTARY INFORMATION:

Background

Regulation J governs the collection of checks and other items by the Reserve Banks. Under existing Regulation J, the term “item” is understood to mean a negotiable instrument in paper form. Regulation J includes the warranties and indemnities that senders and Reserve Banks give for items that are collected or returned through the Federal Reserve Banks. Regulation J also describes the Reserve Banks’ security interest in the assets of banks for which they collect items, as well as the amounts and methods by which the Reserve Banks may recover for their losses associated with collection and return of items. Regulation J authorizes the Reserve Banks to issue operating circulars governing the details of the collection of checks and other items and provides that such operating circulars have binding effect on all persons interested in an item handled by a Reserve Bank. Although the Reserve Banks in some cases handle items electronically today, the rights and obligations associated with electronic items are not set forth in Regulation J but rather are addressed by the Reserve Banks’ Operating Circular No. 3, “Collection of Cash Items and Returned Checks” (OC 3).

The Check 21 Act and the Board's implementing amendments, contained in a new subpart D of Regulation CC, take effect on October 28, 2004.¹ These provisions are designed to facilitate banks' ability to process checks electronically. Today, a bank that accepts a check for collection must collect the original paper check unless the bank to which it sends the check has agreed to receive the check electronically. It is difficult, if not impossible, for a bank to obtain electronic check exchange agreements with all other banks to which it sends checks. If the paying bank demands presentment of the original check, the banks in the collection process for that check must process the original check even if their agreements with one another would allow them to handle the check electronically among themselves. The Check 21 Act addresses this inefficiency by allowing banks to create a new negotiable instrument called a "substitute check" that, when properly prepared, is the legal equivalent of the original check. Under the Check 21 Act, banks can remove the original check from the collection process, handle the check electronically by agreement, and later create a legally equivalent substitute check when and where an original check is required.

A bank that creates a substitute check is known as the "reconverting bank." The reconverting bank makes two new warranties and an indemnity designed to protect substitute check recipients against losses associated with the check substitution process. These warranties are made, in turn, by each bank that subsequently handles the substitute check, whether it remains in paper form or is converted to electronic form.² Under this chain of warranties and indemnities, losses generally will be borne under the Check 21 Act by the reconverting bank, although the Act contains comparative negligence provisions to protect the reconverting bank from losses attributable to another person's fault.

The Check 21 Act allocates losses only among parties that handle a substitute check. However, it is possible that the problem giving rise to liability under the Check 21 Act was the fault of the bank that sent electronic information derived directly from the original check to the reconverting bank. For example, the bank that converted the original check to electronic form and sent it to the reconverting bank might have taken a poor image of the original check, which would preclude the reconverting bank from creating a legally equivalent substitute check and cause it to breach a substitute check warranty. The Check 21 Act does not by its terms give the reconverting bank recourse against its sender in that case. However, the reconverting bank may, by agreement, further allocate losses that it incurs under the Check 21 Act. For example, a bank that plans to create substitute checks could require the bank from which it electronically receives the original check to warrant the accuracy of the image of the original check.

¹ See 69 FR 47290, Aug. 4, 2004. The Reserve Banks will amend OC 3 to address the details of their new check processing services following the Board's adoption of final amendments to Regulation J.

² Regulation CC provides that the warranties and indemnity flow with the transfer, presentment, or return of a substitute check "or a paper or electronic representation of a substitute check." In this preamble, the term "substitute check" includes a paper or electronic representation of that substitute check, unless the context indicates that the reference is to the actual substitute check.

After the Check 21 Act takes effect on October 28, 2004, the Reserve Banks will offer a wider variety of electronic check processing services, including accepting items in electronic form for collection and return. In some cases, an electronic item received by a Reserve Bank will be an electronic representation of a substitute check for which the Reserve Banks will receive Check 21 Act warranty and indemnity protections from the sender and give those protections to subsequent transferees. However, the Reserve Banks anticipate that most of the items that they will receive in electronic form will be derived directly from the original check and thus will not be subject to the substitute check warranties and indemnity. (Unless specifically indicated otherwise, in the remainder of this preamble the term “electronic item” refers to an electronic item derived directly from the original check and does not refer to an electronic representation of a substitute check.) A Reserve Bank in some cases will use an electronic item to create a substitute check for which it must make the Check 21 Act warranties and indemnity. In other cases, the Reserve Bank may transfer or present the electronic item to a subsequent party that creates a substitute check.

Overview of Proposed Rule

The Board in June 2004 published proposed amendments to subpart A of Regulation J that were designed primarily to bring the Reserve Banks’ handling of electronic items within the coverage of Regulation J, acknowledge the requirements of Regulation CC for substitute checks, and add new warranties and an indemnity that would apply when a sender sends an electronic item that is not subject to subpart D Regulation CC.³ The proposed supplemental warranties and indemnity were intended to allow a recipient of an electronic item to pass back subsequent Check 21-related liability to the sender of that item where appropriate. The proposed supplemental warranties and indemnity therefore closely tracked the warranties and indemnity in subpart D of Regulation CC.

The other proposed amendments generally were technical in nature, such as supplementing existing definitions in Regulation J to correspond to definitional changes in Regulation CC and reorganizing and revising some existing regulatory text for greater clarity.

Overview of Comments on the Proposed Rule

The Board received comments on the proposed rule from 41 commenters, including 32 depository institutions and organizations representing depository institutions, six consumers and consumer groups, and three other organizations. The vast majority of commenters agreed that it was appropriate for Regulation J to contain a Check 21-like liability structure for electronic items that would allow Reserve Banks and other recipients of such items to pass back liabilities subsequently incurred under the Check 21 Act. However, commenters expressed concerns about specific aspects of the Board’s proposed liability structure and made suggestions for how the Board could make that structure more equitable. Commenters also encouraged the Board to clarify that the

³ 69 FR 34086, June 18, 2004.

new supplemental warranties and indemnity for electronic items would not alter the liability structure for substitute checks in the Check 21 Act and subpart D of Regulation CC. Specific substantive comments are discussed in more detail in the Section-by-Section Analysis.

Overview of the Board's Final Rule

The Board's final rule is similar to the rule that the Board proposed for comment. However, the Board has made a number of clarifying changes in response to the comments received and its own further analysis. These changes include adjustments to the definition of electronic item and to the liability structure applicable to an electronic item. These changes also state more directly that Regulation J does not alter the liability structure for substitute checks and paper and electronic representations of substitute checks set forth in Regulation CC. Moreover, the final rule provides that a sender of an electronic item makes the Uniform Commercial Code (U.C.C.) transfer warranties for an electronic item as if it were an item subject to the U.C.C. and makes the warranties of § 229.34 of Regulation CC as if the electronic item were a check subject to that section.

Section-by-Section Analysis

This section-by-section analysis focuses on the provisions of the existing or proposed rule that the Board changed or that were the subject of comments or the Board's own further analysis. For all other provisions, the Board's reasoning in the section-by-section analysis of the Board's proposed rule is incorporated by reference.

Section 210.2 Definitions.

A. In General. One commenter suggested that the final rule should use the terms "person" and "party" in a manner consistent with the U.C.C.'s usage of those terms. The Board agrees that Regulation J's word usage should be consistent with the U.C.C. and has made revisions accordingly.

Some commenters asked the Board to clarify that when Regulation J uses the term "handle" with respect to a substitute check, that term refers to a transfer, presentment, or return of a substitute check. These commenters sought clarification that by "handling" a substitute check under Regulation J, the sender would make the substitute check warranties and indemnity described in subpart D of Regulation CC. Regulation J generally uses the term "handle" to refer to a transfer, presentment, or return, as the context requires. However, the substitute check warranties and indemnity are made directly under Regulation CC according to the terms of that regulation, which Regulation J does not alter. The Board's amendments to §§ 210.5 and 210.6, which are discussed in detail in the analysis of those sections, further clarify the interaction between Regulation CC and Regulation J.

B. Item and electronic item. To bring electronic items under the coverage of Regulation J, the Board proposed to amend Regulation J's definition of the term "item"

to include an electronic item. Some commenters requested that the Board ensure that its definition of the term “item” would not affect the U.C.C.’s definition of that term. All the definitions in § 210.2 of Regulation J are prefaced by the phrase “as used in this subpart” and do not apply to any other law or regulation. Thus, the modification of the definition of the term “item” for purposes of Regulation J does not alter the meaning of that term under the U.C.C or the meaning of the term “check” under Regulation CC.⁴

The proposed rule stated that an electronic image of a paper item “together with information describing that item” was an electronic item (emphasis added). The Reserve Banks in some cases will handle in separate files the image portion of an electronic item and the information portion of the item, which would include a record of the magnetic ink character recognition (MICR) line data from the paper item and of any indorsements applied to the item electronically. The final rule therefore changes the phrase “together with” to “and.” The Board also has amended the electronic item definition so that electronic check-related information will not constitute an electronic item unless it is the type of electronic file that a Reserve Bank has agreed to handle as an item. This revision addresses the fact that some check-related information that the Reserve Banks handle electronically is for information purposes only and is not intended for collection as an item or reconversion to a substitute check.

Section 210.3 General Provisions.

Some commenters recommended that the Board clarify in § 210.3(f) that nothing in Regulation J alters the liabilities of persons interested in a substitute check or a paper or electronic representation of a substitute check, as established by the Check 21 Act and subpart D of Regulation CC. As discussed in more detail in the analysis of §§ 210.5 and 210.6, the amendments to Regulation J are not intended to alter the application of the liability provisions of subpart D of Regulation CC. Although the Board has not amended § 210.3 as suggested, the final rule makes the clarification requested by commenters in several other places by indicating that Reserve Banks can be held liable under subpart D (see, e.g., §§ 210.6(a)(2)(iii), 210.6(c), 210.12(e)(2)(iii)), by specifically acknowledging the applicability of Regulation CC to items collected through Reserve Banks (see, e.g., §§ 210.5(a)(5)(i)(C), 210.5(b), 210.12(c)(5)(i)(C), and 210.12(d)), and by stating that nothing in Regulation J alters the liability that senders of substitute checks (or representations thereof) bear under subpart D (see, e.g., §§ 210.5(a)(5)(ii)(B), 210.12(c)(5)(ii)(B)).

Section 210.4 Sending Items to Reserve Banks

The Board proposed to amend § 210.4(b)(1) to clarify that the Administrative Reserve Bank of the paying bank was deemed to have handled an item sent to a Reserve Bank for collection. On further reflection, the Board has deemed that this clarification is not necessary.

⁴ One commenter requested clarification about the application of Regulation E to electronic items. Because Regulation E explicitly excludes transactions originated by check from its coverage, an electronic item under Regulation J does not include an electronic fund transfer subject to Regulation E.

Section 210.5 Sender's Agreement; Recovery by Reserve Bank; Section 210.6 Status, Warranties and Liability of Reserve Bank.

A. Addition of U.C.C. transfer warranties and Regulation CC § 229.34 warranties for all electronic items.

The U.C.C. generally is understood to apply to items in paper form, although it allows a paying bank to agree to receive electronic presentment of an item. When presentment is made electronically by agreement, U.C.C. 4-110 treats the presentment notice as an item or a check as those terms are defined in the U.C.C., and the presenting bank therefore makes the presentment warranties in U.C.C. 4-208 to the paying bank. However, electronic items as defined in Regulation J that are handled for collection rather than presentment might not be items or checks under the U.C.C. and are not checks under Regulation CC. As a result, electronic items sent for collection might not be subject to the transfer warranties in U.C.C. 4-207 and are not subject the check collection warranties in § 229.34(c) of Regulation CC.

To ensure a full chain of U.C.C. transfer warranties and Regulation CC § 229.34(c) warranties for an item that a Reserve Bank receives or sends in electronic form, the Board's final rule adds a paragraph to § 210.5(a) that provides that by sending an electronic item a sender makes all the warranties set forth in and subject to the terms of U.C.C. 4-207 as if the electronic item were an item subject to the U.C.C. and makes the warranties set forth in § 229.34(c) of Regulation CC as if the electronic item were a check subject to that section. Section 210.6(b) contains corresponding Reserve Bank warranties. These new warranties apply to all electronic items, regardless of whether they are derived directly from an original check or from a substitute check. Because senders and Reserve Banks must make these new warranties for an electronic item subject to the terms of U.C.C. 4-207 and § 229.34(c) of Regulation CC, they must make these warranties to all the parties described in U.C.C. 4-207 and § 229.34(c) of Regulation CC.

B. Content of supplemental warranties for electronic items that are not representations of substitute checks.

Under proposed § 210.5(a)(4)(i) and § 210.6(b)(3)(i), the sender of an electronic item would warrant, among other things, that the item "accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated" and "replicates the MICR line of the original check, except for any changes required or permitted by part 229, subpart D of this chapter for substitute checks." Several commenters expressed concern about the use of the word "replicate" when describing the MICR-line content portion of the warranty. These commenters thought that the warranty should distinguish more clearly between the MICR line that appears in the image of the front of the original check and the separate MICR-line information that must accompany that image. These commenters also noted that the word "replicate" might not adequately convey the idea that, when creating the electronic

item, the truncating bank would transfer the MICR-line information that appeared on the original check to a different format.

Several commenters concerned with the MICR-line component of the warranty also suggested that a sender of an electronic item should warrant that the electronic item contains a record of the MICR line as it appeared on the original check at the time of truncation. This suggestion, however, would mean that if the check contained a MICR-line strip that omitted information previously encoded on the original check, only the information contained on the strip would be needed to satisfy the warranty. These comments were submitted prior to the Board's issuance of the final rule amending Regulation CC to implement the Check 21 Act, which requires the substitute check to contain information in all fields of the MICR-line that were encoded on the original check prior to truncation.⁵ The purpose of the MICR-line content warranty for an electronic item derived directly from an original check is to ensure that the electronic item contains all the information necessary for the recipient to create a substitute check that is the legal equivalent of the original check. The Board therefore believes that it is appropriate for a bank to warrant that electronic item contains all the information required for a substitute check.

To address the foregoing issues with respect to the MICR line portion of the warranties made for electronic items, §§ 210.5(a)(4)(i) and 210.6(b)(3)(i) of the final rule state that the sender warrants that "the electronic image portion of the item accurately represents all of the information on the front and back of the original check as of the time that the original check is truncated" and "the information portion of the item contains a record of all MICR-line information required for a substitute check under § 229.2(aaa) of this chapter."

C. Scope of recipients of warranties and indemnity for electronic items.

Several commenters expressed concern that a Reserve Bank makes the warranties in existing and proposed § 210.6(b)(1) to a subsequent collecting bank, the paying bank, and any other payor, yet would make the new warranties and indemnity for electronic items in proposed § 210.6(b)(3) only to the bank to which the Reserve Bank transfers or presents the item. The Board notes that the scope of the supplemental warranties given by senders to Reserve Banks under § 210.5(a)(4) of the final rule is similarly limited. Commenters opined that the Reserve Banks should make the supplemental warranties and indemnity in § 210.6(b)(3) to the same parties that receive the warranties in § 210.6(b)(1).

Section 210.6(b)(1) generally restates existing warranties that Reserve Banks make under the U.C.C., which by the terms of that law flow to subsequent banks in the collection process. Proposed § 210.6(b)(3), by contrast, contains new warranties and an indemnity that Reserve Banks would not otherwise make under the U.C.C. or other law. The Board has retained the more limited scope of warranties that receive the

⁵ See 69 FR 47290, Aug. 4, 2004, at 47310 and 47318.

supplemental warranties for electronic items in § 210.6(b)(3).⁶ A person that receives an electronic item derived directly from an original check from a person other than a Reserve Bank can further protect itself by an agreement with its sender.

D. Scope of sender and Reserve Bank warranties and indemnity for substitute checks and electronic items.

To clarify the full range of warranties and indemnities that apply to items collected by Reserve Banks, the proposed rule listed the check collection warranties in § 229.34(c) of Regulation CC and the substitute check warranties and indemnity in subpart D of Regulation CC. The proposed amendments did not list other liability-related provisions of Regulation CC, such as the general liability provision and the interbank expedited recredit procedure that apply to substitute checks. Several commenters indicated that having a separate regulatory list of warranties and indemnities in Regulation J could cause confusion about how Regulation CC applies to checks handled by Reserve Banks or could suggest that the substitute check-related liability provisions that were not listed would not apply at all.

Many commenters expressed concern that proposed § 210.5(a)(5)(iv)-(v), by which the sender would agree to indemnify the Reserve Bank for losses associated with substitute checks (and representations thereof) and electronic items, respectively, inappropriately would allow a Reserve Bank to pass back losses for which the Reserve Bank was responsible. Commenters particularly were concerned that a Reserve Bank should not be allowed to pass back to a sender any losses that were attributable to the Reserve Bank's fault. The Board believes that the existing liability provisions of Regulation J, which hold a Reserve Bank liable for its own failure to use ordinary care, would have prevented this result. However, the Board notes that § 210.6(b)(3)(ii) of the proposed rule was overbroad because it would have required a Reserve Bank to indemnify the recipient for all its losses regardless of the recipient's fault.

Some of the commenters that were concerned about the equity of the liability structure in the proposed amendments suggested that a sender should not be liable for losses associated with electronic items that were later used to create substitute checks unless the sender breached one of the new warranties in Regulation J. Other commenters thought that any loss attributable to a problem with an electronic item should be passed back to the person that created the electronic item, regardless of whether that person or a subsequent bank in the collection process sent the electronic item to the Reserve Bank.⁷

⁶ The supplemental warranties in Regulation J that apply the U.C.C. 4-207 warranties and Regulation CC § 229.34(c) warranties to electronic items are made to all the parties listed in the U.C.C. and § 229.34(c) of Regulation CC, respectively, which includes all subsequent collecting banks. The broader warrantee scope is appropriate for these supplemental warranties because they are designed to ensure that the existing U.C.C. and Regulation CC warranties continue to flow to all warrantees listed in those provisions regardless of whether the check changes form.

⁷ One commenter suggested that a Reserve Bank should indemnify its transferee for losses associated with an electronic item that is never reconverted into a substitute check. However, the purpose of the new warranties and indemnity for electronic items in Regulation J is to allocate losses incurred when an electronic item that is not subject to the Check 21 Act is used to create a substitute check.

The Board intends that Regulation J acknowledge, but in no way alter, a bank's responsibilities under subpart D of Regulation CC for substitute checks and under § 229.34(c) for all checks. The Board further intends the liability for losses associated with electronic items to parallel the liability structure for substitute checks in Regulation CC as closely as possible, both for senders and for Reserve Banks, and to prevent any person from passing back losses attributable to its own fault.⁸ The Board therefore has significantly reorganized the warranty and indemnity provisions in §§ 210.5 and 210.6 to address the comments on these topics and clarify the rule.

The final rule omits the proposed provisions that restated the existing Regulation CC liability structure and incorporates into other paragraphs of §§ 210.5(a) and 210.6(b) the concept that the Regulation CC warranty and indemnity provisions apply according to their terms. Specifically, § 210.5(a)(5)(ii)(A) provides that senders of original checks are not liable for any amount that the Reserve Bank pays under subpart D of Regulation CC for a subsequently created substitute check or under § 210.6(b) for an electronic item, absent the sender's agreement to the contrary.⁹ Section 210.5(a)(5)(ii)(B) provides that nothing in Regulation J alters the liability structure that applies to substitute checks and paper or electronic representations of substitute checks under subpart D of Regulation CC.¹⁰ Section 210.5(a)(5)(ii)(C) provides that a sender of an electronic item is not liable for any amount a Reserve Bank pays under § 210.6(b)(3) or subpart D of Regulation CC that is attributable to the Reserve Bank's own lack of good faith or failure to exercise ordinary care. Section 210.6(b)(3)(ii)(B) contains substantially similar limitations to those in § 210.5(a)(5)(ii)(C) so that Reserve Banks that handle an electronic item also will not bear substitute check-related losses that are attributable to the fault of a subsequent person in the collection process. The final rule also specifically states that Reserve Banks are subject to subpart D of Regulation CC.

The Board has not, as requested by commenters, amended the indemnity provisions to hold a sender of an electronic item liable for a loss associated with a later substitute check only if the sender breached a Regulation J warranty. The indemnity in subpart D of Regulation CC covers a loss due to the receipt of a substitute check even in the absence of a warranty breach. For example, a substitute check that contains a complete and accurate image of the original check may be insufficient to prove a forgery claim because only the original check could be used for handwriting analysis. Subpart D of Regulation CC would allocate that loss to the reconverting bank. Sections 210.5(a)(5) and 210.6(b)(3) of the final rule further allocate that loss to the first party subject to

⁸ Although the warranties and indemnity in §§ 229.52 and 229.53 are not by their terms fault-based, the amount for which an indemnifying bank ultimately is liable is governed by the comparative negligence provisions of §§ 229.53(b)(2) and 229.56(a)(3).

⁹ A sender that designates certain original checks for accelerated processing could, for example, by the terms of an operating circular agree to indemnify the Reserve Bank for subsequent losses under subpart D of Regulation CC.

¹⁰ Some commenters suggested that the sender of a substitute check should be required to indemnify a Reserve Bank only if the Reserve Bank subsequently transferred a substitute check. The Board notes that the loss allocation for substitute checks in §§ 229.52 and 229.53 of Regulation CC provide that, once a substitute check is created, the warranties and indemnity flow with that item and with any paper or electronic representation of it.

Regulation J that sent the electronic item, which could be the bank that sent the electronic item to the Reserve Bank or the Reserve Bank itself. Thus, Regulation J places the loss with the bank whose choice to handle an item electronically necessitated the later creation of a substitute check.

The final rule also does not, as requested by commenters, allocate losses associated with an electronic item to a person that handled the item prior to the Reserve Bank's sender. The warranties and indemnity in existing and proposed Regulation J are first made by the sender of the item to a Reserve Bank because Regulation J only governs items that are collected by the Reserve Banks. The Board believes that allocating liability for any item in Regulation J to a person prior to the Reserve Bank's sender would be inappropriate, because that person may have no control over whether the item was handled by a Reserve Bank. However, a Reserve Bank's sender that received an electronic item from another person could protect itself through its agreement with that person.

E. Procedures for claims against Reserve Banks.

Several commenters opined that the standard for accrual of a claim for an electronic item that is not a representation of a substitute check in § 210.6(d)(2) should be the same as the accrual standard for substitute check claims in § 229.56(c) of Regulation CC. This is the result intended by the Board, and proposed § 210.6(d)(2) reached this result by using language identical to that in § 229.56(c). The final rule therefore retains the proposed accrual language.

Some commenters expressed concern that the statement in § 210.6(d)(3) of the proposed rule that paragraph (d) "does not lengthen" the time for bringing a claim under Regulation CC implied that paragraph (d) could shorten the otherwise applicable timeframe. The final rule therefore states that § 210.6(d) "does not alter" the time periods for bringing actions under the sections of Regulation CC that it references.

Section 210.12

Section 210.12 sets forth a liability structure for returned checks that is substantially similar to the liability structure in §§ 210.5 and 210.6 that applies to items handled for forward collection. The proposed amendments to § 210.12 therefore closely paralleled the proposed amendments to corresponding portions of §§ 210.5 and 210.6. Accordingly, the final amendments to § 210.12 are identical or substantially similar to those discussed in the analysis §§ 210.5 and 210.6.

Regulatory Flexibility Act

The Board has reviewed the final rule's impact on small banks in accordance with the final regulatory flexibility analysis requirements in the Regulatory Flexibility Act (12 U.S.C. 604).

Under section 3 of the Small Business Act, as implemented at 13 CFR part 121, subpart A, a bank is considered a “small entity” or “small bank” for purposes of the Regulatory Flexibility Act if it has \$150 million or less in assets. Based on June 2004 call report data, the Board estimates that there are approximately 14,221 depository institutions with assets of \$150 million or less. The final amendments will apply to all depository institutions, regardless of size, that obtain check collection services from a Reserve Bank.

As discussed in the preceding sections, the final amendments are necessary to facilitate the electronic collection of checks by Reserve Banks as contemplated by the Check 21 Act. Commenters generally supported the proposed amendments and did not submit comments on the Regulatory Flexibility Act section. The primary effect of the final amendments is to provide that each bank that sends an electronic item to a Reserve Bank for forward collection or return would make warranties and an indemnity for that item. The new warranties and indemnity in Regulation J are similar to the warranties and indemnity that apply to paper checks under existing Regulation J and other law. Although the Reserve Banks could protect themselves with respect to electronic items by agreement, the Board believes that it is appropriate at this time to bring electronic items within the coverage of Regulation J. The final amendments generally apply only to those banks that choose to send items to Reserve Banks electronically. These amendments do not require any bank to change the form in which it submits checks, nor do they require any bank to submit reports, maintain records, or provide notices or disclosures.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed the final rule under the authority delegated to the Board by the Office of Management and Budget. The final rule contains no new collections of information and proposes no substantive changes to existing collections of information pursuant to the Paperwork Reduction Act.

Administrative Procedure Act

The Board has found good cause that the final amendments should take effect on October 28, 2004. The Check 21 Act takes effect on that date and is designed to facilitate the electronic processing of checks. Without a warranty and indemnity structure for electronic items derived directly from original checks, such as that in the final amendments, the Reserve Banks cannot offer a wider range of electronic check processing services as anticipated by the Check 21 Act. To maximize banks’ ability to use the Federal Reserve’s new electronic check processing services facilitated by the Check 21 Act, the effective date of Regulation J should coincide with the effective date of the Act. Moreover, the Board notes that no bank is required to change its check processing procedures as a result of the rule and that the new provisions of the final rule generally apply only to those banks that choose to send items electronically to the Reserve Banks. The final rule also does not impose any reporting, recordkeeping, or reporting requirements for any bank. Accordingly, having the amendments take effect on

October 28 should provide benefits to those banks that want to rely on the Check 21 Act to process checks electronically without any countervailing disadvantages to those or any other banks. For the foregoing reasons, the Board has determined that good cause exists for making the rule effective on October 28, 2004, to coincide with the effective date of the Check 21 Act.

12 CFR Chapter II

List of Subjects in 12 CFR Part 210

Banks, banking.

Authority and Issuance

For the reasons set forth in the preamble, the Board is amending 12 CFR part 210 to read as follows:

PART 210—COLLECTION OF CHECKS AND OTHER ITEMS BY FEDERAL RESERVE BANKS AND FUNDS TRANSFERS THROUGH FEDWIRE (REGULATION J)

1. The authority citation for part 210 is revised to read as follows:

Authority: 12 U.S.C. 248(i), (j), and (o), 342, 360, 464, 4001-4010, and 5001-5018.

§ 210.1 [Amended]

2. In § 210.1, add the phrase “the Check Clearing for the 21st Century Act (12 U.S.C. 5001-5018);” between the phrases “the Expedited Funds Availability Act (12 U.S.C. 4001 et seq.);” and “and other laws” in the first sentence.

§ 210.2 [Amended]

3. In § 210.2 make the following changes:

- (A) Revise the last sentence of paragraph (h);
- (B) Revise paragraphs (i), (l)(3), and (n);
- (C) Remove the undesignated paragraph after paragraph (o);
- (D) Revise paragraph (r); and
- (E) Add a new paragraph (s).

The revisions and addition read as follows:

§ 210.2 Definitions.

* * * * *

(h) * * * Check as defined in 12 CFR 229.2(k) means an item defined as a check in 12 CFR 229.2(k) for purposes of subparts C and D of part 229.

(i) Item and electronic item.

(1) Item means—

(i) An instrument or a promise or order to pay money, whether negotiable or not, that is—

(A) Payable in a Federal Reserve District¹ (District);

(B) Sent by a sender to a Reserve Bank for handling under this subpart; and

(C) Collectible in funds acceptable to the Reserve Bank of the District in which the instrument is payable; and

(ii) An electronic image of an item described in paragraph (i)(1)(i) of this section, and information describing that item, that a Reserve Bank agrees to handle as an item pursuant to an operating circular.

(2) Electronic item means an item described in paragraph (i)(1)(ii) of this section.

Note: Unless otherwise indicated, item includes both a cash and a noncash item, and includes a returned check sent by a paying or returning bank. Item does not include a check that cannot be collected at par, or a payment order as defined in § 210.26(i) and handled under subpart B of this part.

* * * * *

(1) * * *

(3) The bank whose routing number appears on a check in the MICR line or in fractional form (or in the MICR-line information that accompanies an electronic item) and to which the check is sent for payment or collection.

* * * * *

¹ For purposes of this subpart, the Virgin Islands and Puerto Rico are deemed to be in the Second District, and Guam, American Samoa, and the Northern Mariana Islands in the Twelfth District.

(n) Sender means any of the following entities that sends an item to a Reserve Bank for forward collection—

(1) A depository institution, as defined in section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b));

(2) A clearing institution, defined as—

(i) An institution that is not a depository institution but that maintains with a Reserve Bank the balance referred to in the first paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342); or

(ii) A corporation that maintains an account with a Reserve Bank in conformity with § 211.4 of this chapter (Regulation K);

(3) Another Reserve Bank;

(4) An international organization for which a Reserve Bank is empowered to act as depository or fiscal agent and maintains an account;

(5) A foreign correspondent, defined as any of the following entities for which a Reserve Bank maintains an account: a foreign bank or banker, a foreign state as defined in section 25(b) of the Federal Reserve Act (12 U.S.C. 632), or a foreign correspondent or agency referred to in section 14(e) of that act (12 U.S.C. 358); or

(6) A branch or agency of a foreign bank maintaining reserves under section 7 of the International Banking Act of 1978 (12 U.S.C. 347d, 3105).

* * * * *

(r) Uniform Commercial Code and U.C.C. mean the Uniform Commercial Code as adopted in a state.

(s) Terms not defined in this section. Unless the context otherwise requires—

(1) The terms not defined herein have the meanings set forth in § 229.2 of this chapter applicable to subpart C or subpart D of part 229 of this chapter, as appropriate; and

(2) The terms not defined herein or in § 229.2 of this chapter have the meanings set forth in the Uniform Commercial Code.

§ 210.3 [Amended]

4. In § 210.3(b) remove the phrase “subpart C” and add the phrase “subparts C and D” in its place.

§ 210.4 [Amended]

5. In paragraph 210.4(b)(2), remove the word “party” and add the word “person” in its place.

§ 210.5 [Amended]

6. In § 210.5 make the following changes:

(A) Revise paragraph (a);

(B) Redesignate paragraphs (b), (c), and (d) as paragraphs (c), (d), and (e), respectively and add a new paragraph (b);

(C) Revise newly designated paragraph (c)(3);

(D) In the first sentence of newly designated paragraph (d)(1), remove the phrase “paragraph (b)” and add the phrase “paragraph (c)” in its place;

(E) Redesignate the last sentence of newly designated paragraph (d)(2) as paragraph (d)(3); in newly designated paragraphs (d)(2) and (d)(3), remove the phrase “paragraph (c)” wherever it appears and add the phrase “paragraph (d)” in its place; and in newly designated paragraph (d)(3) remove the phrase “paragraph (a)(3)” and add the phrase “paragraph (a)(5)” in its place; and

(F) In the first sentence of newly designated paragraph (e), remove the phrase “subpart C of” between the word “or” and the phrase “part 229.”

The revisions and addition read as follows:

§ 210.5 Sender’s agreement; recovery by Reserve Bank.

(a) Sender's agreement. The warranties, authorizations, and agreements made pursuant to this paragraph may not be disclaimed and are made whether or not the item bears an indorsement of the sender. By sending an item to a Reserve Bank, the sender does all of the following.

(1) Authorization to handle item. The sender authorizes the sender's administrative Reserve Bank and any other Reserve Bank or collecting bank to which the item is sent to handle the item (and authorizes any Reserve Bank that handles settlement for the item to make accounting entries), subject to this subpart and to the Reserve Banks' operating circulars, and warrants its authority to give this authorization.

(2) Warranties for all items. The sender warrants to each Reserve Bank handling the item that—

(i) The sender is a person entitled to enforce the item or authorized to obtain payment of the item on behalf of a person entitled to enforce the item;

(ii) The item has not been altered; and

(iii) The item bears all indorsements applied by parties that previously handled the item, in paper or electronic form, for forward collection or return.

(3) Warranties for all electronic items. The sender makes all the warranties set forth in and subject to the terms of 4-207 of the U.C.C. for an electronic item as if it were an item subject to the U.C.C. and makes the warranties set forth in and subject to the terms of § 229.34(c) of this chapter for an electronic item as if it were a check subject to that section.

(4) Warranties for electronic items that are not representations of substitute checks. If an electronic item is not a representation of a substitute check, the sender of that item warrants to each Reserve Bank handling the item that—

(i) The electronic image portion of the item accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated; the information portion of the item contains a record of all MICR-line information required for a substitute check under § 229.2(aaa) of this chapter; and the item conforms to the technical standards for an electronic item set forth in an operating circular; and

(ii) No person will receive a transfer, presentment, or return of, or otherwise be charged for, the electronic item, the original item, or a paper or electronic representation of the original item such that the person will be asked to make payment based on an item it already has paid.

(5) Sender's liability to Reserve Bank. (i) Except as provided in paragraph (a)(5)(ii) of this section, the sender agrees to indemnify each Reserve Bank for any loss or expense sustained (including attorneys' fees and expenses of litigation) resulting from—

(A) The sender's lack of authority to make the warranty in paragraph (a)(1) of this section;

(B) Any action taken by the Reserve Bank within the scope of its authority in handling the item; or

(C) Any warranty or indemnity made by the Reserve Bank under § 210.6(b) of this subpart, part 229 of this chapter, or the U.C.C.

(ii) A sender's liability for warranties and indemnities that the Reserve Bank makes for a substitute check, a paper or electronic representation thereof, or any other electronic item is subject to the following conditions and limitations-

(A) A sender of an original check shall not be liable under paragraph (a)(5)(i) of this section for any amount that the Reserve Bank pays under subpart D of part 229 of this chapter or under § 210.6(b)(3) of this subpart, absent the sender's agreement to the contrary;

(B) Nothing in this subpart alters the liability of a sender of a substitute check or paper or electronic representation of a substitute check under subpart D of part 229 of this chapter; and

(C) A sender of an electronic item that is not a representation of a substitute check shall not be liable for any amount that the Reserve Bank pays under subpart D of part 229 of this chapter or § 210.6(b)(3)(ii) of this subpart that is attributable to the Reserve Bank's own lack of good faith or failure to exercise ordinary care.

(b) Sender's liability under other law. Nothing in paragraph (a) of this section limits any warranty or indemnity by a sender (or a person that handled an item prior to the sender) arising under state law or regulation (such as the U.C.C.), other federal law or regulation (such as part 229 of this chapter), or an agreement with a Reserve Bank.

(c) * * *

(3) Any warranty or indemnity made by the Reserve Bank under section 210.6(b) of this subpart, part 229 of this chapter, or the U.C.C.,

* * * * *

§ 210.6 [Amended]

7. In § 210.6 make the following changes:

(A) Revise paragraphs (a) and (b); and

(B) Redesignate paragraph (c) as paragraph (d), add a new paragraph (c), and revise newly designated paragraph (d).

The revisions and additions read as follows:

§ 210.6 Status, warranties, and liability of Reserve Banks.

(a)(1) Status. A Reserve Bank that handles an item shall act as agent or subagent of the owner with respect to the item. This agency terminates when a Reserve Bank receives final payment for the item in actually and finally collected funds, a Reserve

Bank makes the proceeds available for use by the sender, and the time for commencing all actions against the Reserve Bank has expired.

(2) Limitations on Reserve Bank liability. A Reserve Bank shall not have or assume any liability with respect to an item or its proceeds except—

(i) For the Reserve Bank's own lack of good faith or failure to exercise ordinary care;

(ii) As provided in paragraph (b) of this section; and

(iii) As provided in subparts C and D of Regulation CC.

(3) Reliance on routing designation appearing on item. A Reserve Bank may present or send an item based on the routing number or other designation of a paying bank or nonbank payor appearing in any form on the item when the Reserve Bank receives it. A Reserve Bank shall not be responsible for any delay resulting from its acting on any designation, whether inscribed by magnetic ink or by other means, and whether or not the designation acted on is consistent with any other designation appearing on the item.

(b) Warranties and liability. The following provisions apply when a Reserve Bank presents or sends an item.

(1) Warranties for all items. The Reserve Bank warrants to a subsequent collecting bank and to the paying bank and any other payor that—

(i) The Reserve Bank is a person entitled to enforce the item (or is authorized to obtain payment of the item on behalf of a person that is either entitled to enforce the item or authorized to obtain payment on behalf of a person entitled to enforce the item);

(ii) The item has not been altered; and

(iii) The item bears all indorsements applied by parties that previously handled the item, in paper or electronic form, for forward collection or return.

(2) Warranties for all electronic items. The Reserve Bank makes all the warranties set forth in and subject to the terms of 4-207 of the U.C.C. for an electronic item as if it were an item subject to the U.C.C. and makes the warranties set forth in and subject to the terms of § 229.34(c) of this chapter for an electronic item as if it were a check subject to that section.

(3) Warranties and indemnity for electronic items that are not representations of substitute checks. (i) If the electronic item is not a representation of a substitute check, the Reserve Bank warrants to the bank to which it transfers or presents that item that—

(A) The electronic image portion of the item accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated; the information portion of the item contains a record of all MICR-line information required for a substitute check under § 229.2(aaa) of this chapter; and the item conforms to the technical standards for an electronic item set forth in an operating circular; and

(B) No person will receive a transfer, presentment, or return of, or otherwise be charged for, the electronic item, the original item, or a paper or electronic representation of the original item such that the person will be asked to make payment based on an item it already has paid.

(ii) If the item is an electronic item that is not a representation of a substitute check—

(A) Except as provided in paragraph (b)(3)(ii)(B) of this section, the Reserve Bank agrees to indemnify the bank to which it transfers or presents the electronic item (the recipient bank) for the amount of any losses that the recipient bank incurs under subpart D of part 229 of this chapter for an indemnity that the recipient bank was required to make under subpart D of part 229 of this chapter in connection with a substitute check later created from the electronic item.

(B) The Reserve Bank shall not be liable under paragraph (b)(3)(ii)(A) of this section for any amount that the recipient bank pays under subpart D of part 229 of this chapter that is attributable to the lack of good faith or failure to exercise ordinary care of the recipient bank or a person that handled the item, in any form, after the recipient bank.

(c) Limitation on liability. A Reserve Bank shall not have or assume any liability to the paying bank or other payor, except as provided in paragraph (b) of this section, § 229.34(c) or subpart D of part 229 of this chapter, or for the Reserve Bank's own lack of good faith or failure to exercise ordinary care.

(d) Time for commencing action against Reserve Bank. (1) A claim against a Reserve Bank for lack of good faith or failure to exercise ordinary care shall be barred unless the action on the claim is commenced within two years after the claim accrues. Such a claim accrues on the date when a Reserve Bank's alleged failure to exercise ordinary care or to act in good faith first results in damages to the claimant.

(2) A claim that arises under paragraph (b)(3) of this section shall be barred unless the action on the claim is commenced within one year after the claim accrues. Such a claim accrues as of the date on which the claimant first learns, or by which the claimant reasonably should have learned, of the facts and circumstances giving rise to the claim.

(3) This paragraph (d) does not alter the time limit for claims under section 229.38(g) of this chapter (which include claims for breach of warranty under § 229.34 of this chapter) or subpart D of part 229 of this chapter.

§ 210.12 [Amended]

8. In § 210.12 make the following changes:

(A) In paragraph (b)(2), remove the word “party” and add the word “person” in its place;

(B) Revise paragraph (c);

(C) Redesignate paragraphs (d), (e), (f), (g), (h), and (i) as paragraphs (e), (f), (g), (h), (i), and (j), respectively, and add a new paragraph (d);

(D) Revise newly designated paragraphs (e) and (f)(3);

(E) In newly designated paragraph (g), remove the phrase “paragraph (d)” and add the phrase “paragraph (e)” in its place; remove the phrase “paragraph (f)” wherever it appears and add the phrase “paragraph (g)” in its place; and remove the phrase “paragraph (c)(3)” and add the phrase “paragraph (c)(5)” in its place.

The revisions and addition read as follows:

§ 210.12 Return of cash items and handling of returned checks.

* * * * *

(c) Paying bank's and returning bank's agreement. The warranties, authorizations, and agreements made pursuant to this paragraph may not be disclaimed and are made whether or not the returned check bears an indorsement of the paying bank or returning bank. By sending a returned check to a Reserve Bank, the paying bank or returning bank does all of the following.

(1) Authorization to handled returned check. The paying bank or returning bank authorizes the paying bank's or returning bank's administrative Reserve Bank, and any other Reserve Bank or returning bank to which the returned check is sent, to handle the returned check (and authorizes any Reserve Bank that handles settlement for the returned check to make accounting entries) subject to this subpart and to the Reserve Banks' operating circulars.

(2) Warranties for all returned checks. The paying bank or returning bank warrants to each Reserve Bank handling a returned check that the returned check bears all indorsements applied by parties that previously handled the returned check, in paper or electronic form, for forward collection or return.

(3) Warranties for all returned checks that are electronic items. A paying bank or returning bank that sends a returned check that is an electronic item makes the returning bank warranties set forth in and subject to the terms of § 229.34 of this chapter for the electronic item as if it were a check subject to that section.

(4) Warranties for returned checks that are electronic items that are not representations of substitute checks. If the returned check is an electronic item that is not a representation of a substitute check, the paying bank or returning bank warrants to each Reserve Bank handling the returned check that—

(i) The electronic image portion of the item accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated; the information portion of the item contains a record of all MICR-line information required for a substitute check under § 229.2(aaa) of this chapter; and the item conforms to the technical standards for an electronic item set forth in an operating circular; and

(ii) No person will receive a transfer, presentment, or return of, or otherwise be charged for, the electronic item, the original item, or a paper or electronic representation of the original item such that the person will be asked to make payment based on an item it already has paid.

(5) Paying bank or returning bank's liability to Reserve Bank. (i) Except as provided in paragraph (c)(5)(ii) of this section, a paying bank or returning bank agrees to indemnify each Reserve Bank for any loss or expense (including attorneys' fees and expenses of litigation) resulting from—

(A) The paying or returning bank's lack of authority to give the authorization in paragraph (c)(1) of this section;

(B) Any action taken by a Reserve Bank within the scope of its authority in handling the returned check; or

(C) Any warranty or indemnity made by the Reserve Bank under paragraph (e) of this section or part 229 of this chapter.

(ii) A paying bank's or returning bank's liability for warranties and indemnities that a Reserve Bank makes for a returned check that is a substitute check, a paper or electronic representation thereof, or any other electronic item is subject to the following conditions and limitations—

(A) A paying bank or returning bank that sent an original check shall not be liable for any amount that a Reserve Bank pays under subpart D of part 229 of this chapter or under § 210.12(e)(1)(iii) of this subpart, absent the paying bank's or returning bank's agreement to the contrary;

(B) Nothing in this subpart alters the liability under subpart D of part 229 of this chapter of a paying bank or returning bank that sent a substitute check or a paper or electronic representation of a substitute check; and

(C) A paying bank or returning bank that sent an electronic item that is not a representation of a substitute check shall not be liable under paragraph (c)(5)(i) of this section for any amount that the Reserve Bank pays under subpart D of part 229 of this chapter or paragraph (e)(1)(iii) of this section that is attributable to the Reserve Bank's own lack of good faith or failure to exercise ordinary care.

(d) Preservation of other warranties and indemnities. Nothing in paragraph (c) of this section limits any warranty or indemnity by a returning bank or paying bank (or a person that handled an item prior to that bank) arising under state law or regulation (such as the U.C.C.), other federal law or regulation (such as part 229 of this chapter), or an agreement with a Reserve Bank.

(e) Warranties by and liability of Reserve Bank. (1) The following provisions apply when a Reserve Bank handles a returned check under this subpart.

(i) Warranties for all items. The Reserve Bank warrants to the bank to which it sends the returned check that the returned check bears all indorsements applied by parties that previously handled the returned check, in paper or electronic form, for forward collection or return.

(ii) Warranties for all returned checks that are electronic items. A Reserve Bank that sends a returned check that is an electronic item makes the returning bank warranties set forth in and subject to the terms of § 229.34 of this chapter as if the electronic item were a check subject to that section.

(iii) Warranties and indemnity for returned checks that are electronic items that are not representations of substitute checks.

(A) If the returned check is an electronic item that is not a representation of a substitute check, the Reserve Bank warrants to the bank to which it sends the returned check that—

(1) The electronic image portion of the item accurately represents all of the information on the front and back of the original check as of the time that the original check was truncated; the information portion of the item contains a record of all MICR-line information required for a substitute check under § 229.2(aaa) of this chapter; and the item conforms with the technical standards for an electronic item set forth in an operating circular; and

(2) No person will receive a transfer, presentment, or return of, or otherwise be charged for, the electronic item, the original item, or a paper or electronic representation

of the original item such that the person will be asked to make payment based on an item it already has paid.

(B) If the returned check is an electronic item that is not a representation of a substitute check—

(1) Except as provided in paragraph (e)(1)(iii)(B)(2) of this section, the Reserve Bank agrees to indemnify the bank to which it sends the returned check (the recipient bank) for the amount of any losses that the bank incurs under subpart D of part 229 of this chapter for an indemnity that the bank was required to make under subpart D of part 229 of this chapter in connection with a substitute check later created from the returned check.

(2) A Reserve Bank shall not be liable under paragraph (e)(1)(iii)(B)(1) of this section for any amount that that the recipient bank pays under subpart D of part 229 of this chapter that is attributable to the lack of good faith or failure to exercise ordinary care of the recipient bank or a person that handled the item, in any form, after the recipient bank.

(2) A Reserve Bank shall not have or assume any other liability to any person except-

(i) As provided in paragraph (e)(1) of this section;

(ii) For the Reserve Bank's own lack of good faith or failure to exercise ordinary care as provided in subpart C of part 229 of this chapter; or

(iii) As provided in subpart D of part 229 of this chapter.

(f) * * *

(3) Any warranty or indemnity made by the Reserve Bank under paragraph (e) of this section or part 229 of this chapter,

* * * * *

§ 210.13 [Amended]

9. In § 210.13, remove the word “party” wherever it appears and add the word “person” in its place, and remove the citation “§ 210.9(a)(5)” and add the citation “§ 210.9(b)(5)” in its place.

By order of the Board of Governors of the Federal Reserve System, October 22, 2004.

Robert deV. Frierson (signed)

Robert deV. Frierson,
Deputy Secretary of the Board.